R&D Credits – What Your Co-Op Needs to Know

Stan Babicz, Principal
John Kapral, Principal
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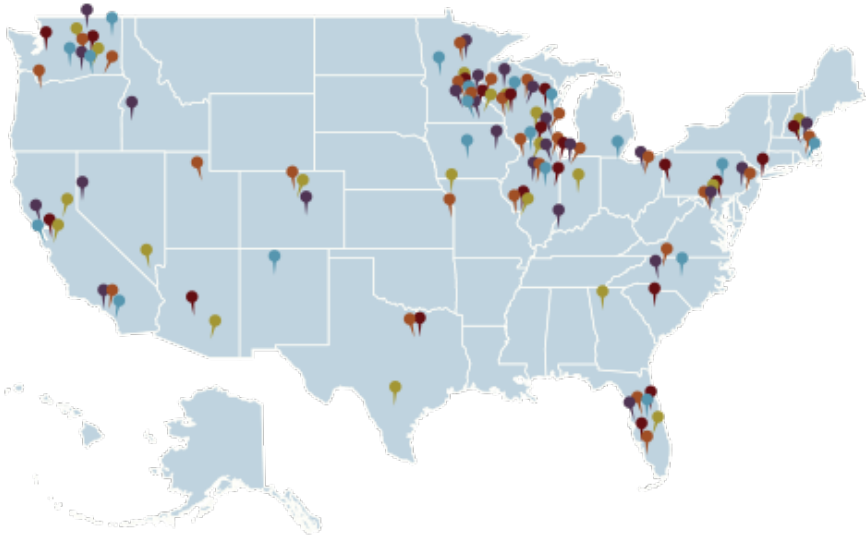
- A professional services firm with three distinct business lines
  - Wealth Advisory
  - Outsourcing
  - Audit, Tax, and Consulting
- More than 5,000 employees
- Offices coast to coast
- We serve nearly 500 cooperatives.



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Speaker Introductions

Stan Babicz, Principal

Stan is a principal in the firm's Milwaukee, WI office. He has more than 30 years of public accounting experience and specializes in tax planning services for a wide range of companies. Stan is also the regional federal tax solutions practice leader, and is responsible for the development and delivery of advanced tax planning strategies to our clients.

John Kapral, Principal

John is the R&D tax credits lead for the firm's Southwest region. He has worked in specialty tax credits and incentives since 2006, serving a diversity of companies and industries. He has also practiced as a tax transactions and controversies attorney, and as a technology transfer business consultant to US government labs.

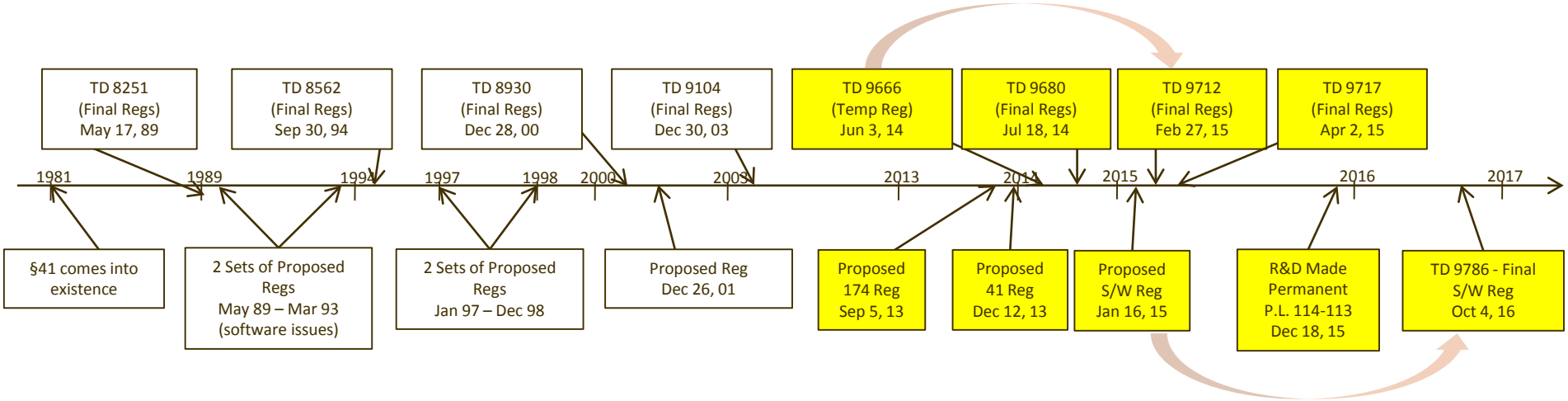
Rebecca Smith, Director

Rebecca has more than 16 years of tax experience in public accounting and has an extensive background providing tax planning and compliance for privately held companies, serving primarily cooperatives and the agribusiness industry as well as manufacturers. Rebecca serves as the Cooperative National Tax Director for the firm.

Learning Objectives

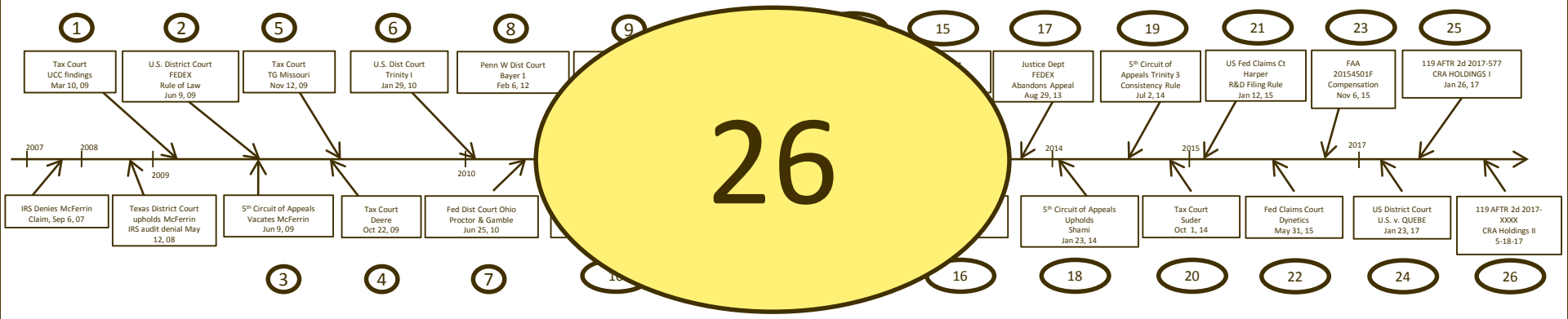
- The webinar will review:
  - The R&D credit and the four-part test
  - Examples of what qualifies as research and development
  - How to properly identify and document expenses
  - Calculation of the credit
  - Potential risks

Research Credit Foundations



R&D is a 30+ Year Old Credit that has Undergone Significant Revision
9 New Regulations in ~3 Years

Case Law Summary



R&D Tax Credit: The Four-Part Test

Qualified Research Activity

Permitted Purpose

Research shall be conducted for a permitted purpose if it relates to— a new or improved function; performance; or reliability or quality.

IRC 41(d)(1)(B)(ii)

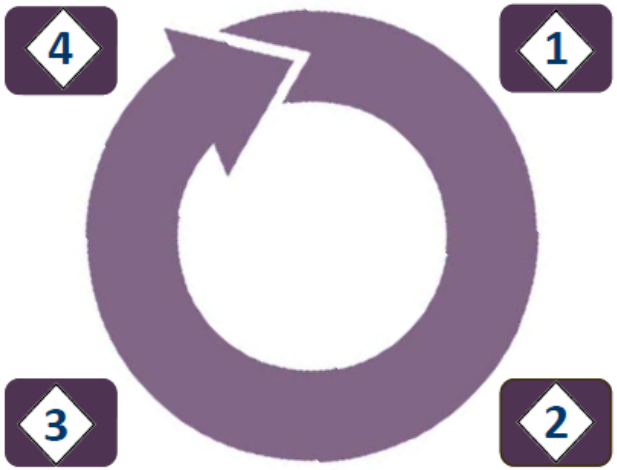
"We tried to…."

Technological in nature

A process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science.

IRC 41(d)(1)(B)(i)

"We relied on ___science…"



Eliminate Uncertainty

Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.

IRC 41(d)(1)(A)

"We were uncertain how to…"

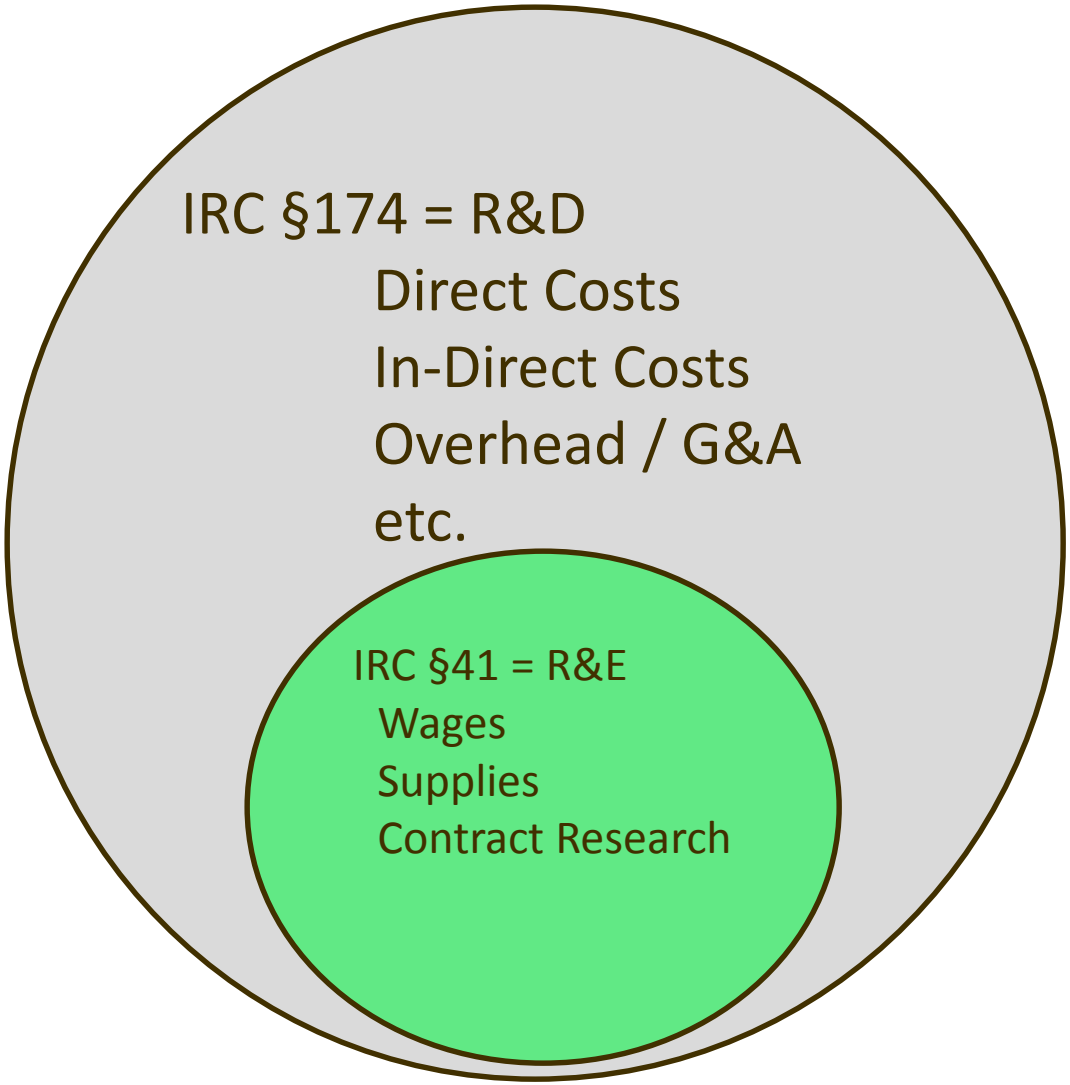
Process of Experimentation

Substantially all of the activity must constitute as a process of experimentation, substantially all being defined as 80 percent (or more).

IRC 41(d)(1)(C)

"We tested…"

The Entire Picture



Experimental or laboratory sense = discover info that eliminates "product" development/improvement uncertainty

- Hands on, direct support & direct supervision allowed
- Patent = safe harbor
- New to client (not to world)
- Pilot Model, Process, Formula, Invention, or Technique

Qualifying R&D Activities: Exclusions

- Research after commercial production
- Adaptation of an existing business component
- Duplication of an existing business component
- Surveys, studies, market research, routine data
- Research outside of the United States & territories
- Funded research – grants, contracts, or by another person
- Quality assurance / quality control / ordinary testing
- Management studies

R&D Tax Credit Changes in 2016

- Now permanent
- May offset Alternative Minimum Tax
  - Only Qualified Small Businesses with less than $50M in gross receipts
- May offset the first $250,000 of taxpayer's portion of Payroll Tax (FICA)
  - Only Qualified Small Business Start Ups with less than $5M in gross receipts in current year and no gross receipts for any taxable year preceding the 5-taxable year ending with such taxable year (Notice 2017-23)

R&D Opportunities for Agricultural Cooperatives

Business and General Tax Issues:

- Identify the new Business Component (i.e. purpose of R&D must be for a new or improved product or process).
- Income tax appetite needed to absorb the credits.
- Nature of business relationship with Members is important to understand whether the Cooperative performing the R&D or is contracting Members to conduct R&D, and is the organization willing to conduct R&D activities so to qualify for using the credits (structuring, internal accounting, licensing terms, fee payments)?

R&D Opportunities for Agricultural Cooperatives

Specific Tax Accounting Issues:

- Evaluate controlled group issues (>50% actual or constructive ownership by Members)
- Funded research if no risk of economic loss and retention of substantial IP rights by party conducting the R&D
- Is the cooperative involved with developing agricultural business components (projects or processes or improvements) that are technological in nature with uncertainty at the outset of the best or most appropriate approach, resolved through a process of experimentation?

Markers for R&D Credit Potential in Agricultural Businesses

Accounting & Financial:

- Significant R&D payroll (i.e. Ph.D.'s, scientists and researchers such as agronomists, zoologists, botanists, microbiologists, geneticists, chemists, mechanical or electrical engineers and software programmers)
- Timekeeping / tracking system (common issue in agriculture; if weak or none can be evidentiary problem)
- Scaled production processes
- Numerous patents, formulas, and trade secrets (IP assets)

Markers for R&D Credit Potential in Agricultural Businesses

Technological:

- Frequent use of sample or test crop beds, plots, plantings, or breeding techniques
- Onsite lab / clean rooms
- Outsourced lab support and testing services
- Machinery & equipment design and construction
- Unique packaging needs
- Numerous patents, formulas, and trade secrets

Product Development in Agriculture

- Organic food products
- Improved nutritional attributes
- High yield strains and varieties
- Better livestock through genetics and breeding programs
- Natural pesticides and microbe resistance by genetic engineering of crops
- Natural & organic fertilizers
- Development of climate resilient fruits and vegetables
- Low water use / arid condition crops through genetic research and experimentation

Process Improvements in Agriculture

- Processes improving health, safety or yield techniques from testing technological principles
- Low water use by development of new irrigation systems
- Efficiencies of scale from new or improved equipment
- "Smart" farming techniques deploying apps, sensors, software, and blockchain technology
- Reduced environmental impact through sustainability, renewables, and waste reduction
- Spec or self-constructed machinery and equipment
- Packaging designs and materials for improved shelf life and decreased spoilage in transit

Agricultural Machinery & Equipment Development

- Planting & harvesting machinery
  - "Red or Green" chile pickers
- Use of GPS and cloud devices for monitoring employees, facilities, crops, and livestock
  - Timekeeping tools
- Storage and transportation facilities and equipment
- Integration of robotics, vehicles, software, and telecommunications applications and devices
  - Blockchain identification and tracing in the food supply chain

Examples of Qualifying Agricultural R&D

Qualified

- Creating new strains, seeds or plant material in the lab through genetic engineering or general plant science.
  - A patent is not required, and formulas and trade secrets are evidentiary
  - Seed producers have been a common area of success.

Not Qualified

- Routine growers.
  - Experimentation with simple crop practices such as alternative spacing, planting depths, or watering conditions would be challenged.
  - Supplies used that would create saleable product are not qualified (Union Carbide).

Proving Nexus: Documentation

- **"Nexus"** establishes proof qualified R&D activities occurred through documentation connecting People to Projects by Tasks and showing Purpose
  - Ex: Nutrient evaluations of experimental crops
  - Ex: Alpha QA & QC functional and qualitative test results
  - Ex: Soil sample and chemical analytics
  - Ex: Proposals discussing alternatives and outcome goals
  - Ex: Activity timeline logs and Wikis
  - Ex: Progress and technical reports and milestone analysis
  - Ex: Series of schematic designs showing markups

Appetite for the Credit

- Cooperative
  - Income Tax Liability
    - ◊ Nonpatronage business income
    - ◊ Retained patronage business income (Amount retained and not paid as a patronage dividend)
  - Offset up to $250,000 payroll tax liability
    - ◊ Only Qualified Small Business Start Ups with less than $5M in gross receipts and no gross receipts for any taxable year preceding the 5-taxable year being filed (2012 forward)
  - 20 year carry forward
- Patrons
  - Credit cannot be passed through

CliftonLarsonAllen Approach

- Phase I - Initial Assessment
  - Determine framework to establish Nexus between qualifying activities and expenses
  - Estimate potential credits
  - Determine utilization of benefit
  - Go/no-go recommendation
- Phase II - Substantiation
  - Construct actual Nexus between qualifying activities and expenses
  - Document activities & Finalize Credit Calculation
  - File on tax return – potentially 4 returns

GOAL: Minimize Impact on Client – Maximize Benefit – Create Audit Support

Questions?

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